

**Chicago Board of Trade**

C.F.T.C.

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President and
Chief Executive Officer

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September 8, 1998

OFFICE OF THE SECRETARIAT

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Secretary
Commodity Futures Trading Commission
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COMMENT

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COMMODITY FUTURES
TRADING COMMISSION
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**Re: Petition of the London Clearing House Limited for Exemption
Pursuant to Section 4(c) of the Commodity Exchange Act,
63 Federal Register 36657 (July 7, 1998)**

The Board of Trade of the City of Chicago ("CBOT®") appreciates the opportunity to submit our comments on the petition (the "Petition") filed by the London Clearing House ("LCH") for an exemption, pursuant to Section 4(c) of the Commodity Exchange Act, in connection with the LCH's proposed provision of clearing services for certain swap agreements and forward rate agreements (collectively "Swaps") published for comment on July 7, 1998.

At the outset, we emphasize that the CBOT is not opposed to centralized clearing of OTC Swaps. Indeed, the CBOT has long believed that the over-the-counter derivative market would greatly benefit from the addition of an established clearing house such as the Board of Trade Clearing Corporation or the LCH to the OTC derivatives market. In this regard, we disagree with the Commission's position, stated in its pending Concept Release on regulation of OTC Derivatives, that "a greater need may exist for oversight of the operations of a clearing organization than for any single participant in an uncleared market" because the "benefits" of clearing "are obtained at the cost of concentrating risk in the clearing organization." (63 Fed. Reg. 26114, 26122 (May 12, 1998).)

However, we are opposed to the granting of piecemeal exemptions from the clearing ban imposed by the Part 35 Rules, especially when U.S. based clearing organizations are prohibited from playing such a role by the restrictive clearing-related provisions of Part 35 and Part 36. Instead of granting a specific exemption for the exclusive benefit of the LCH, a foreign entity, the Commission should develop a generic framework for allowing Swaps clearing which would be available equally to all clearing organizations, including those affiliated with U.S. futures exchanges.

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I. THE COMMISSION SHOULD NOT GRANT PIECEMEAL EXEMPTIONS TO THE REQUIREMENTS OF PART 35

From the beginning, the Commission has taken the position that Swaps that were cleared by a common entity would not qualify for the less-restrictive regulatory regime of Part 35. In the Part 35 Adopting Release, the Commission pronounced that

the [Part 35] exemption does not extend to transactions that are subject to a clearing system where the credit risk of individual members of the system to each other in a transaction to which each is a counterparty is effectively eliminated and replaced by a system of mutualized risk of loss that binds members generally whether or not they are counterparties to the original transaction.

54 Fed. Reg. 5587, 5591 (January 22, 1993). This past May, the Commission reaffirmed that "[the c]learing of swaps is not permitted under Part 35." 63 Fed. Reg. 26114, 26115 (May 12, 1998).

The Commission should not grant piecemeal exemptions from Part 35's longstanding ban against clearing facilities for OTC Swaps transactions. U.S. exchanges and clearinghouses, including the CBOT and Board of Trade Clearing Corporation, have in the past considered offering similar Swaps clearing services to those now proposed by LCH. In our case, we were discouraged from devoting substantial resources to our initiative in the face of indications from the CFTC that it opposed expansion of the Part 35 exemptive relief to accommodate exchange proposals for Swaps clearing facilities. Indeed, the Commission adopted the centralized clearing ban in the Part 35 Rules over the CBOT's objections that the restriction would artificially deny exchanges the benefit of the Part 35 Rules. Subsequently, the Commission rejected the CBOT's ProMarket petition seeking an exemption for exchange markets comparable to the Part 35 relief for the OTC markets.¹ Further, the Commission expressly excluded clearinghouse rules from the special expedited approval procedures of the Part 36 exemptive rules it adopted in October 1995 in lieu of our ProMarket petition, indicating caution toward clearing facilities for exchange-traded Swaps in spite of the recognized and proven benefits of exchange markets. (Moreover, as described below, the exchanges went

¹ The CBOT submitted our ProMarket petition in June 1993, and later modified our petition in December 1994 as part of our comments during the rulemaking procedures for the CFTC's Part 36 Rules. The Commission has yet to formally act on our petition, but implicitly rejected it by adopting the Part 36 rules as alternative relief.

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through a protracted rulemaking process to obtain the wholly-inadequate Part 36 exemptive relief.)

Thus, the Commission should first develop a regulatory framework, generally available to all exchanges and clearing organizations, for offering of Swaps clearing before acting upon the LCH's petition. To grant the LCH the exemptive relief it seeks in the absence of such a framework would give the LCH an unwarranted competitive advantage of being first in the Swaps-clearing market. Further, if the Commission grants the Petition, it would enable a foreign entity, the LCH, to gain a nearly insurmountable lead toward a monopoly in the clearing of OTC Swaps before the U.S. based clearinghouses have an opportunity to compete, to the detriment of the U.S. derivatives industry.

II. THE COMMISSION SHOULD DEFER ACTING UPON THE LCH PETITION UNTIL IT HAS COMPLETED THE CONCEPT RELEASE PROCESS FOR RECONSIDERING ITS REGULATION OF OTC DERIVATIVES

The Commission's pending Concept Release on regulation of OTC derivatives (63 Fed. Reg. 26114 (May 12, 1998)) confirms that Swaps clearing raises broad policy issues that should not be handled on an ad hoc basis through piecemeal exemptive requests.² In the Concept Release, the Commission expressed the belief that it needed to "reexamine its regulatory approach to the OTC derivatives market. . . ." 63 Fed. Reg. at 26115. One of the issues that the Commission specifically cited was its position that the "[c]learing of swaps is not permitted under Part 35." 63 Fed. Reg. at 26115. In the Concept Release, the Commission solicited comments on a number of issues related to allowing central clearing of OTC Swaps. The Commission should resolve those issues first before considering specific proposals for expanding the exemptive relief afforded by Part 35 to accommodate Swaps clearing to avoid pre-judging issues on which it has solicited comment. To act otherwise, the Commission would render as meaningless the public comment process by foreclosing public dialogue on those issues.

For example, the Commission sought comments on the fundamental issue of the appropriate elements of regulatory oversight of an OTC swap clearing organization. Granting the LCH's petition will result in regulatory oversight standards set by the

² The comment period on the OTC Derivatives Concept Release was to close on July 13, 1998. The Commission subsequently extended the comment period to September 11, 1998. 63 Fed. Reg. 34225 (June 24, 1998). It is our understanding that the Commission is considering granting a further 30 day extension.

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U.K.'s Financial Services Authority's becoming the world's benchmark, notwithstanding the comments received by the Commission.³

Another issue that the Commission considered relevant to its review of OTC derivatives regulation was the extent to which cleared Swaps would be similar to exchange-traded products. The Commission also asked for advice on how it can best promote fair competition and even-handed regulation between the related products. In its Petition, the LCH makes the simple declaration that its Swap Clear program would not compete with exchange-trade products because, among other things, the contracts cleared by the LCH will not be standardized.

The terms of the Swaps to be cleared by the LCH will likely tend toward standardization, if only to qualify for clearing. The most likely scenario is an ever-increasing standardization over time to facilitate secondary trading in the Swaps contracts among the participants in the market, the SwapClear Dealers and the SwapClear Clearing Members. Thus, the LCH could become an incubator for a new type of futures-like market. In any event, if the Commission grants the Petition, it will do so without any meaningful analysis of the likelihood that the unregulated market for LCH-cleared Swaps will directly compete with exchange-traded products. Given the impact such competition could have on both the exchanges and the market participants, the Commission should not make what could prove to be one of its most significant decisions in the context of an isolated exemptive petition. A decision of this magnitude should come only after a full debate among affected parties and after appropriate deliberation on that debate by the Commission.

Recently, it has been Commission practice to subject most novel or innovative initiatives proposed by the CBOT or other exchanges into the concept release process. For example, the Commission has deferred consideration of our proposal regarding an exchange of agricultural futures for OTC agricultural options until it fully examined all of the issues in its broader policy review announced in its Regulation of Noncompetitive Transactions Executed on or Subject to the Rules of a Contract Market Concept Release⁴ ("Noncompetitive Trade Release"). The Commission also withheld

³ Of course, the Commission could also choose to grant the LCH's Petition and yet still impose more restrictive standards on U.S.-based clearing houses once it has completed the lengthy Concept Release process, but this would only serve to augment the hegemony over the clearing of OTC Swaps that the LCH would likely have as a result of its being the first to offer clearing services to that market.

⁴ 63 Fed. Reg. 3708 (January 26, 1998).

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approval of the New York Mercantile Exchange's proposed rule to permit an exchange of futures contracts for a swap agreement. This application, too, was folded into the Noncompetitive Trade Release. Similarly, when the CBOT filed its previously-mentioned ProMarket exemptive petition, the Commission raised some 100 specific policy issues on which it sought public comment and held round table discussions on the implications of the petition. Surely the issues raised in the LCH's Petition warrant at least the same degree of careful consideration that was paid to the initiatives of the CBOT and NYMEX.

More on point, the Commission recently retreated from a piecemeal approach for responding to requests of foreign exchanges to allow placement of their electronic trading terminals within the U.S. without contract market designation because of the international dimension and potential implications for U.S. exchanges. In lieu of considering individual no-action requests, the Commission is currently soliciting comments on this matter through the concept release process. Commission action on the LCH petition without first establishing an appropriate generic regulatory framework would be at variance with this precedent.

CONCLUSION

Instead of granting the exemptive relief requested by the LCH that would only apply to the LCH, the U.S. derivatives industry would be better served by generic relief available for all clearinghouses, both domestic and foreign. The Commission has initiated a process for developing such standards through its OTC Derivatives Concept Release. Alternatively, the Commission could use the information and analysis from the concept release process as a basis for working with the industry to develop legislative proposals for addressing swaps clearing. This approach makes sense given Congress' stated intention to review OTC derivatives regulation more generally during next year's legislative sessions. Either way, it is important that the Commission recognize that the only acceptable scheme for the regulation of centrally cleared OTC Swaps is one that provides a level playing field to all potential Swaps clearinghouses.

Sincerely,



Thomas R. Donovan